Internal Revenue Service

memorandum

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FS:IT&A:JAWright/TDMoffitt

date: DEC 16 199[illegible]

to: District Counsel, Los Angeles CC:LA
Attn: Erin M. Collins

from: Assistant Chief Counsel (Field Service) CC:FS

subject: Deferral of Loan Fees-[redacted]

This is in response to your request for tax litigation advice dated May 30, 1991, (now field service advice) seeking clarification of a December 28, 1984, National Office Technical Advice Memorandum issued to the [redacted]. Further, you requested advice as to whether an accrual basis lending institution may defer loan fees (points) charged to a borrower in originating a mortgage using the loan liquidation method.

ISSUES

1. What is the proper method of accounting for loan fees (points) for [redacted] for the taxable years ending [redacted].

2. Whether [redacted] may defer loan fees (points) charged to a borrower utilizing the loan liquidation method for the taxable years ending [redacted].

3. What is the proper method of accounting for points other than section 461(g)(2) points for lenders after December 31, 1986.

CONCLUSION

1. I.R.C. § 461(g)(2) points provided by the borrower at closing are fully includible in [redacted]'s gross income in the year of settlement. Anticipated regulation changes may alter this treatment prospectively. Points that are not section 461(g)(2) points and that are also de minimis under section 1273 are includible in [redacted]'s gross income as payments on the note are received, unless the loan is sold by the lender prior to maturity. In such a case, the points related to the portion of the loan sold should be included in the lender's gross income in the year of sale to the extent that the sale proceeds exceed the adjusted basis in that portion that was sold. Points that are

not section 461(g)(2) points and that are not de minimis under section 1273 are governed by section 1273.

2. For the taxable years [redacted] and [redacted], [redacted], and other similarly situated lending institutions, should be permitted to account for the section 1273 de minimis points received, other than section 461(g)(2) points, under the loan liquidation method, however, if the loans were sold during these years the related unaccounted for points must be included in the lender's income for the year of sale to the extent that the sales proceeds exceed the adjusted basis in the portion that was sold. Also, the taxpayer's use of the loan liquidation method should be reviewed to ensure that it is being properly applied.

3. If the lender was required under section 448 to change to the accrual method, then the lender cannot utilize its same loan liquidation method for years after 1986. (There may be, however, some methods which are permissible for an accrual basis taxpayer and that are very similar to loan liquidation.) Conversely, if a cash basis lender was not required to change its method it can still use the loan liquidation method for section 1273 de minimis points other than section 461(g)(2) points. Notwithstanding this, if a lender has sold all or a portion of a loan, no part of the portion that was sold may be accounted for under either the loan liquidation method or the composite method. In such a case, the related points should be included in the lender's gross income currently in total or in the same proportion as the loan sold to the extent that the sales proceeds exceed the adjusted basis in the portion that was sold.

FACTS

On [redacted], the National Office granted permission to [redacted] to utilize the loan liquidation method of accounting for reporting its loan fees beginning with the taxable year ending [redacted]. Use of the loan liquidation method of accounting was authorized by the National Office for cash basis taxpayers. Under the loan liquidation method, a lending institution, using the cash receipts and disbursement method, determines the amount of interest received from loans made at a discount by applying the percentage that the amount of loan principal liquidated during each month bears to the total loan principal outstanding at the beginning of the month to the unearned interest applicable to such loans. In contrast, the composite method was authorized for lending institutions whose overall method of accounting is the accrual method. The composite method is essentially equivalent to a straight line amortization of each tax period's total loan fees using a life of 7 to 10 years.

On December 28, 1984, the National Office issued a Technical Advice Memorandum revoking the August 25, 1965, ruling letter

that had authorized [redacted] to utilize the loan liquidation method.[1] The revocation was effective for the taxable years beginning after [redacted]. Consequently, the agent examining [redacted] has raised a question as to the proper treatment for discounted loan fees for the taxable years ending [redacted], and [redacted]. During this two year period, [redacted] was a cash basis taxpayer. Due to the enactment of I.R.C. § 448, effective January 1, 1987, all lending institutions meeting the requirements of section 448 were required to change from the cash method of accounting to the accrual method of accounting. However, there are lending institutions which are still utilizing the loan liquidation method for purposes of reporting the loan fees. Further, there are lending institutions which continue to include discounted points in gross income ratably as payments on the notes are received, even though the entire loan, or a portion thereof, has been sold to a third party.

DISCUSSION

1. What is the proper method of accounting for loan fees (points) for [redacted] for the taxable years ending [redacted], and [redacted].

In preparing for litigation in Bell Federal Savings and Loan Assoc. v. Commissioner, T.C. Memo. 1991-368, the Chief Counsel made the determination that we would apply the following analysis only in the context of section 461(g)(2) points which the lender has a contractual right to receive such points. The Chief Counsel believed that there should be symmetry between the deduction by the borrower of section 461(g)(2) points and the inclusion in income of these points by the lender. It is possible that this position will be substantially altered due to an anticipated reconsideration of the policy behind this position in the near future. This litigation position was upheld in Bell Federal (copy attached), and remains Service position at present. Section 461(g)(2) points consist of those points which are customary and nonexcessive and paid with respect to a loan incurred in connection with the purchase or improvement of, and secured by, the borrower's principal residence.

Accordingly, a determination must be made, if the audit has sufficiently developed the facts on this issue, as to whether the loan fees received by [redacted] for the taxable years ending [redacted], and [redacted], were section 461(g)(2) points. Such points are includible in income in the year of receipt. If they

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[1] We interpret this memorandum as revoking [redacted]'s use of the loan liquidation method only for points paid with "fresh funds" of the borrower, and where the lender had a contractual right to receive the points/fresh funds.

are not section 461(g)(2) points and are de minimis under section 1273 they would be includible in gross income over the life of the loan as payments are received since [redacted] was a cash basis taxpayer. If the points are both non-461(g)(2) and non-de-minimis then the OID rules control.

Similarly, a determination should be made, if the audit has sufficiently developed the facts on this issue, as to whether loans have been disposed of without including in income unrecognized points. To the extent that such dispositions have occurred and to the extent that the taxpayer does not prove that the points associated with such loans were section 461(g)(2) points, an adjustment should be made to include these unamortized points in income. Under section 1012 the discounted points were never included in the lender's basis in the loan and thus, upon disposition, the gain would be increased due to this lowered basis. Consequently, if the loan is sold at a loss the loss will be reduced. Under section 1001 this gain would be taken into income, as the gain in a sale of property is defined as the difference between the "amount realized" on the sale and the "adjusted basis" of the property sold. Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985). See also Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503 (1991).

If this adjustment is to be made, care will need to be taken to ensure that the proper proportion of the unrecognized points is included in income to match the proportion of the loan that was disposed. If further issues arise regarding the proper proportion to be included in income further field service advice can be sought.

In regard to the section 461(g)(2) points, the same arguments that were made in Bell Federal should be made in this case; i.e., section 451, assignment of income[2] and symmetry between the borrower and lender for deduction and inclusion in income of section 461(g)(2) points.

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income of the taxpayer for the tax year in which received by taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period.

Treas. Reg. § 1.451-1(a) provides that under the cash receipts and disbursements method of accounting items of income are includible in gross income when actually or constructively received. Treas. Reg. § 1.451-1(a) also provides that under the accrual method of accounting, income is includible in gross

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[2] Constructive receipt would be a more precise rationale than assignment of income.

income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Although Rev. Rul. 70-540, 1970-2 C.B. 101, amplified by Rev. Rul. 74-607, 1974-2 C.B. 149, antedates the adoption of the Service's litigating position (which is confined to section 461(g)(2) points), it provides guidance on the issue of whether points have been "paid". That ruling considers several factual situations in which amounts are charged to the borrower as points (stipulated to constitute interest under Rev. Rul. 69-188, 1969-1 C.B. 54) and service fees in a real estate mortgage lending transaction. In situation (1) of the ruling, the amount of the "points" is paid at settlement to the lender by the borrower with "fresh funds" (funds not originally obtained from the lender). In such a case the ruling holds that under either the cash or accrual method of accounting the lender is required to include the points in gross income for the year of payment.

This argument was upheld in Bell Federal. Additionally, the Court in Bell Federal held that based on the facts of that case, since the petitioner received the enjoyment of the points it must recognize them into income in the year received. The Court did not comment on the assignment of income argument. It did however note that the Service limited the inclusion of income to the lender to only section 461(g)(2) points.

Care should be taken to avoid encouraging the court to adopt a broad section 451 rationale, unconstrained by section 461(g)(2). Further opinions as broad as that in Bell Federal may make it more difficult to sustain deficiencies under Notice 89-21, 1989-1 C.B. 651. See also Prop. Reg. § 1.446-3.

2. Whether [redacted] may defer loan fees (points) charged to a borrower utilizing the loan liquidation method for the taxable years ending [redacted], and [redacted].

You also raised the question of whether in [redacted] and [redacted] could use the loan liquidation method for points not presently includible in income. The examiner has proposed requiring [redacted] to use the composite method for [redacted] and [redacted]. Although [redacted] was required to change from the cash method of accounting to the accrual method, effective for the tax year beginning [redacted], this is not sufficient justification to require [redacted] to use the composite method of accounting for any deferred points. As aforementioned, [redacted] was a cash basis taxpayer during the period at issue. Accordingly, Rev. Rul. 64-278, 1964-2 C.B. 120, permits [redacted] to utilize the loan liquidation method of accounting for these funds to the extent they are de minimis under section 1273. To require [redacted] to use the composite method of accounting prior to it

becoming an accrual basis taxpayer may be seen as arbitrary, capricious, and an abuse of discretion. Therefore, for the taxable years ending [redacted], and [redacted], [redacted] should be permitted to use the loan liquidation method to account for points that are not section 461(g)(2) points and that are de minimis under section 1273.

It is well established that the Commissioner has considerable power to compel an accounting method change when he determines that the taxpayer's method of accounting does not clearly reflect income. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). The Commissioner, however, does not have the power to require a taxpayer to change from a method of accounting which clearly reflects income to any other method he finds preferable. Hallmark Cards v. Commissioner, 90 T.C. 26 (1988). Rev. Rul. 64-278, 1964-2 C.B. 120, permits a cash basis taxpayer to use the loan liquidation method, since it clearly reflects income. Thus, the fact that the lenders should be changing to the accrual method beginning January 1, 1987, does not constitute sufficient justification for requiring [redacted] and other lenders to change from the loan liquidation method for fees on loans originated prior to 1987.

However, nothing in the above discussion should be read to discourage taking a close look at the taxpayer's use of the loan liquidation method to see if it is being applied properly. Frequent errors in the use of the loan liquidation method are believed to occur due to failure to remove disposed loans from the calculation of the denominator of the fraction used to determine the amount of interest received. Similarly, the deferral of point income past disposal of the underlying loan is an improper application of the loan liquidation method. If facts are developed which appear to disclose an improper use of the loan liquidation method further field service advice could be sought on those issues.

3. What is the proper method of accounting for points other than section 461(g)(2) points for lenders after January 1, 1987.

Beginning in 1987, all lending institutions which met the requirements of section 448 were required to switch from the cash basis method of accounting to the accrual basis method. Consequently, these lenders were also required to change from the cash basis loan liquidation method beginning with the 1987 taxable year for de minimis points under section 1273. However, there are many lending institutions still utilizing the loan liquidation method for purposes of reporting the loan fees. This situation raises three issues:

a) What method of accounting must a lending institution use for its remaining loan liquidation balance for loans made prior to 1987.

b) Whether lending institutions utilizing the loan liquidation method to account for fees on loans should be compelled to change to the composite method beginning with the 1987 taxable year.

c) Whether the change from the cash basis loan liquidation method requires the consent of the Commissioner.

Issue (a) has particular relevance to [redacted] since a lending institution must use its remaining loan liquidation balance for loans made prior to 1987. The Savings & Loan ISP team believes that the loan liquidation balance of these institutions should be written off under the loan liquidation method and that all new points (points, other than section 461(g)(2) points, on loans originated after December 31, 1986) should be reported under the composite method. However, if a taxpayer was required under section 448 to change to the accrual method of accounting on January 1, 1987, then, as part of that overall change, the taxpayer would be required to restate the loan liquidation balance and use the composite method or another method consistent with its change to the accrual method. The restated balance is reflected in the section 481(a) adjustment. As the change from the loan liquidation to composite method is part of the overall change of accounting from cash to accrual under section 448, section 448(d)(7)(C) treats the change as being made with the Commissioner's consent.

However, should all or any part of the loan be sold by the lender prior to maturity, neither the loan liquidation nor the composite method should be permitted. Instead, the unrecognized portion of the points relating to the portion of the loan sold should be taken into gross income of the lender currently (in the year the loan is sold) as discussed above.

As to issue (b), in regard to those lending institutions still utilizing the loan liquidation method to account for points that are de minimis under section 1273, other than section 461(g)(2) points, there are two possible answers. If they were required to change to the accrual method under section 448, then they were required to use the composite method or another method consistent with the change to the accrual method beginning with the 1987 taxable year. A lender which was required to change to the accrual method of accounting under section 448, and after January 1, 1987, is still using the same loan liquidation method for points is using an impermissible method. Therefore, the lender must change to the composite or another method of accounting consistent with the accrual method. A lender which was not required under section 448, to change to the accrual method can still utilize the loan liquidation method for points

that are de minimis under section 1273 and that are not section 461(g)(2) points, for loans made either before or after December 31, 1986. Again, anticipated regulation changes may alter this analysis prospectively. Also, the lender must include in income in the year of sale points attributable to any loan or portion of a loan that it has sold to the extent that the sales proceeds exceed the adjusted basis of the portion sold.

Finally, as to issue (c), we turn to the question of whether National Office approval is necessary for the change from the loan liquidation method to the composite method. If this change is made pursuant to the overall method change from cash to accrual required by section 448, such a change would not require National Office approval. However, if this change was not made pursuant to an overall change under section 448, then National Office approval would be required for the reasons discussed below.

Under section 446(b), if a taxpayer's method of accounting does not clearly reflect income, the Commissioner may require the taxpayer to recompute his income under a method which, in the Commissioner's opinion, does clearly reflect income. Section 446(e) and Treas. Reg. § 1.446-1(e)(2)(i) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Treas. Reg. § 1.446-1(e)(2)(ii) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any "material item" used in the plan. A material item, as defined in section 1.446-1(e)(2)(ii)(a), is one that "involves the proper time for the inclusion of the item in income or the taking of a deduction."

Based on the above regulations, the Commissioner's consent would be required before the lenders could change to the composite method. The loan liquidation method and the composite method are two separate computational methods for accounting for points. Consequently, the Service's consent is necessary to change to the composite method.

This response has been coordinated with Income Tax and Accounting and Financial Institutions and Products. If you have any questions, please call Thomas Moffitt, at FTS 566-3521.

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Attachments:
Bell Federal Opinion
Bell Federal Brief

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